DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92038

36 Letters per Year – $125 Annually

Registered with the Securities Exchange Commission

December 12, 1975 Letter 650

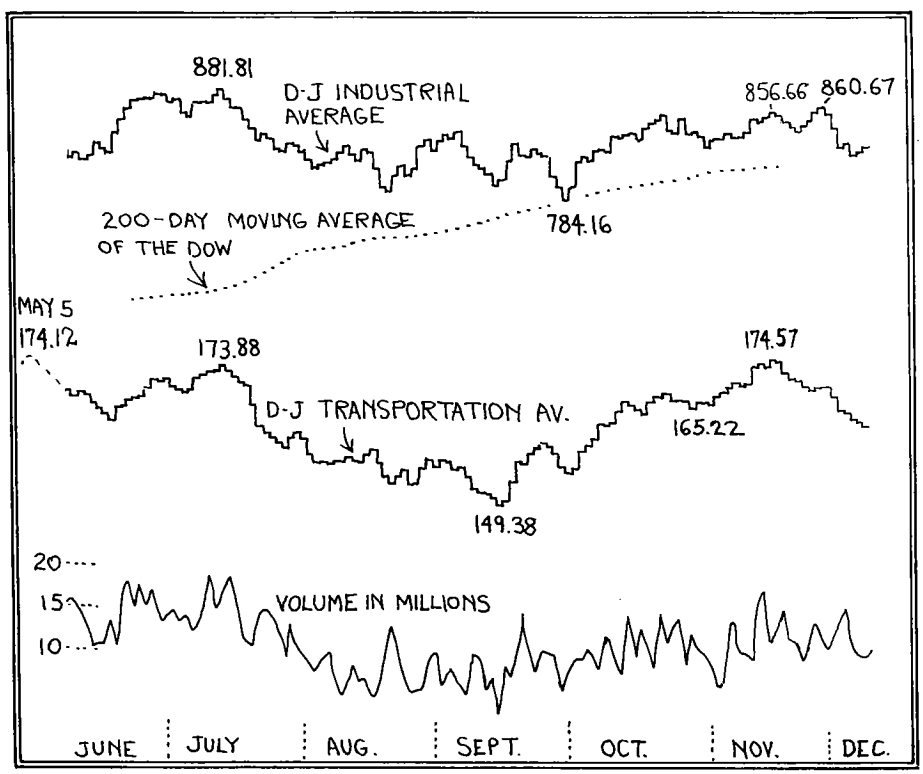
THE PICTURE: Many readers may have been surprised when, over the past few weeks, I changed my intermediate-term stance from bullish to bearish. I changed my stance because in the space of those few weeks the market structure weakened dramatically and many of the previous plusses turned to minuses.

In Letter 648 I drew attention to the new 1975 recovery high (November 17) in the D-J Transportation Average. I noted that this high had not been confirmed by Industrials. Nevertheless, I added, in the majority of such cases the lagging Average will confirm, given enough time.

Then on November 26 (Letter 649) the Special Warning Letter was mailed. That Letter noted that the little cracks in the price structure had a very good chance of turning into ominous crevices. The Industrial Average, by refusing to confirm the new 1975 recovery high in the Transportation Average, had produced an important non-confirmation. But Transports (see page 1 chart) suddenly turned weak following their November 17 peak. Letter 649 warned: If the weaker Industrial Average now pushes above its own November 17 peak of 856.66, and if Transports fail to confirm the new high, we will then have a dangerous double non-confirmation. This is the most powerful reversal structure that can appear in the Averages, Letter 649 stated, and if it materializes, subscribers should move to the sidelines.

On November 28 the Industrial Average climbed to a peak of 860.67. Transports failed by a wide margin to confirm (actually, Transports hardly budged upwards — see chart). Thus, the double non-confirmation had materialized! The next day (Dec. 1) saw a 4.33 drop in the Dow, and this was followed (Dec. 2) by a 13.14 drop in the Dow. On December 3 the market did something that I never like to see — it broke wide open following a distribution pattern, a distribution pattern which had formed under the preceding high (and when I say "under the preceding high" I am referring to the market as measured by any of the unweighted averages or the A-D ratio or the D-J Industrials, for that matter).

On what I consider the fateful day of December 3, the Dow lost 17.71 points, Transports lost 2.62 points, volume surged to over 21 million shares, and the violence of the decline produced a downside "gap" in the Industrial Average (the gap, in my opinion, was produced by the exhaustion of buying power). By Friday, December 5, the Industrial and Transport Averages had broken all preceding decline points going back to early October. I want to stress that the December 3 crack came in the absence of any visible news event — it was purely technical in nature. And these are the kind of declines which I find most disturbing, the ones that occur for no obvious reason.



I want to repeat again (and emphasize) that I did not like (1) the double non-confirmation pattern that was produced by the Averages, (2) the fact that the double non-confirmation occurred with the Dow a full 21 points under its previous July 15 peak, (3) the fact that the double non-confirmation was followed only three days later by a high-volume smash in the Averages and in the A-D ratio, (4) the fact that there was no news on which to blame the decline.

In my experience, the kind of action we have been getting here in early-December indicates that the stock market sees "something" ahead that it does not like. The market is saying that there is something wrong with the generally accepted economic script, and all the hopes and wishes in the world aren't going to change

that. For the benefit of newer subscribers, I might as well state that it is fruitless (and usually very costly) to argue with the Averages. When you argue with Wall Street, you are going to end up poorer (and if you possess the quality of humility you will probably end up wiser). But why argue at all when you can play it the safe way? After all, when the train is coming, even the village idiot knows enough to get off the tracks.

Question: Russell, I'm confused. During October you announce that the secondary trend of the market is bullish and that buying is in order. Then in your Special Warning Report of November 26 you point to your double non-confirmation and issue bearish sounds. How can you change your mind so quickly? I can't keep up with you!

Answer: Hold it, take it easy. I haven't changed my mind about the primary trend of the market. I believe we are still in a primary bull market. But the secondary trend began to look shaky to me around mid-November, and then when a potential double non-confirmation appeared, I did what I always do when I believe the market is "talking": (1) I listen to the best of my ability, and (2) I inform my subscribers.

I've said this before, but I'll say it again: The stock market doesn't arrange itself to suit Richard Russell and his readers. The market tells its emotionless story, and we have two choices: (1) We can listen and act on the implications of the Averages and the technical indicators, or (2) we can stick with our own preconceived scripts. Those who let the market do the talking usually manage to remain solvent, and (believe it or not) they often stay well ahead on their market transactions. Those who cling stubbornly to their personal theories regarding what the market "has to do " usually end up wearing patched pants and shirts that are frayed around the collar.

The logical procedure in this business would probably be for me to publish two reports, one when the primary trend turned bullish, the other when it turned bearish. That might entail my sending out about two reports every three to ten years! But the reason I publish 36 Letters a year is because things change, stocks rally and decline, stock groups change their positions, people like to know what's going on, and they like to know as often as possible. Thus, I mail a Dow Theory Letter every ten days instead of every ten years. It's as simple as that.

Question: I purchased a sizable portfolio or stocks in early October, and I'm about even on my purchases? Are you saying that I should sell those shares out now? How about the taxes?

Answer: I consider it good "insurance" to move to the sidelines when it appears that the secondary trend of the market is turning down. Secondary reversals are always difficult to catch, although secondary tops are usually harder to identify than secondary bottoms (the bottoms arrive faster and in more dramatic fashion). Nevertheless, just as the man who buys term insurance doesn't curse his luck when he outlives his insurance period, the man who sells out when the market appears toppy shouldn't bemoan his financial fate when a full-fledged secondary correction fails to materialize.

As far as taxes are concerned, if you insist on riding out downward reactions, the odds are that the market will solve your tax problems for you in short order. To put it bluntly, before the secondary is over, you probably won't have any tax problem to worry about.

Question: You had suggested a portfolio position of roughly 1/3 cash or equivalent, 1/3 closed-end stock funds and 1/3 closed-end bond funds. I was wondering whether you consider the closed-end stock and bond funds as true "stocks," and whether you were referring to these issues when you advocated lightening positions or getting on the sidelines.

Answer: Well, I certainly do not consider the closed-end bond funds to be common stocks in the usual sense. These funds hold bonds and in some cases preferred stocks too, but they should move with the bond market rather than with the stock market. I would not sell the bond funds at this time.

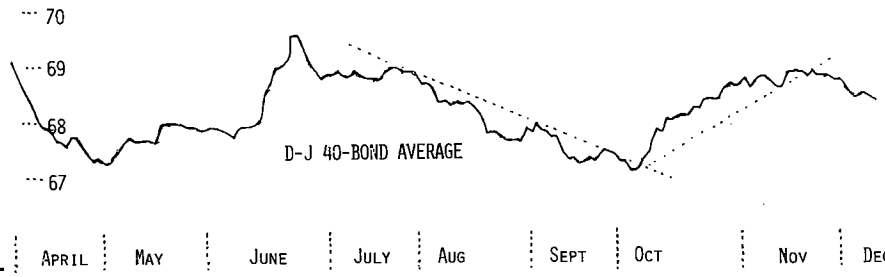
I note that the bond indices which I follow are looking somewhat toppy, and they are rolling over under their previous highs. This could mean that we will have a period of rising interest rates and lower bond prices, but I nevertheless consider the bond funds well worth holding for income. I also feel that their downside loss potential is quite limited.

As for the closed-end stock funds, these funds were already selling at discounts of up to 30%, and I tend to think they will be rather resistant to downside action from here, regardless of whether the secondary trend of the market continues down. In general, the closed-end funds offer value in that they tend to sell at large discounts from asset value. I see nothing wrong with holding a very conservative position in these funds through a reaction but do not hesitate to scale back some if you feel your position is too large. Remember, the closed-end funds cannot collapse like a very weak individual issue, since they are so diversified. Obviously, I would not recommend holding closed-end funds through a primary bear market.

Question: Where would you hold your cash?
Answer: I feel that one of the best places to hold cash is in one of the various liquid assets funds or money-market funds. Here interest is paid on a daily basis, and interest rates fluctuate with the short-term money market. Yale Hirsch has performed a valuable service by publishing a directory of money-market funds. Write Hirsch Org., PO Box 120, Old Tappan, NJ 07675 and enclose $1.

Question: You mention rising money rates. How do you reconcile this with a sloppy stock market?
Answer: Well, I don't feel it's my duty to have to "reconcile" anything — I just report on the action. The accompanying chart shows the daily progress of the D-J 40-Bond Average, and as you can see, the 40-Bonds have not made it through their

preceding peak. Now they look as if they want to drop lower. This is occuring in the face of a rather sloppy stock market.



Why is this happening? One guess is that the NYC pension funds have been selling hundreds of millions of dollars worth of corporate bonds to raise money for the big "loan-bailout" of the City. Another guess is that investors have become edgy about owning all but the highest grade bonds, and they are selling a lot of less-than top grade issues. A third guess is that the bond market is simply correcting after a very substantial run-up. A final guess is that the need for liquidity and money (on the part of the public and private sectors) is running higher than the bond market thought it would, and bonds are coming down as they discount large new offerings in 1976.

But for whatever reason, the bond market is taking a rest here. I continue to feel that the primary trend of the bond market, like the stock market, is bullish however. I don't believe the massive double bottom of 1970-74 in the 40-Bond Average is going to be broken (see Letter 644, page 3).

Question: Russell, you say that you believe we are in a basic or long-term primary bull market. What would you think if the September-October lows of 784.16 (Industrials) and 149.38 (Transports) were broken?

Answer: Well, first I'll say that I would be surprised if the September-October lows were jointly broken. But then — I've been surprised before. IF — the 784.16 and 149.38 lows are smashed on rising volume, I would take a very dim view of the market picture. I would remain (via the seat of my pants) bullish on the primary trend, but I would ACT as if the primary trend was down. That means that I would want to be at zero level as far as holdings of common stocks were concerned. In my experience, the old adage that "the market can do anything" is a good one. The market can indeed do anything, including making fools of us all.

Question: What do you mean, Russell, when you say that if the September-October lows are broken you would remain bullish on the primary trend but you would "act" as if the primary trend was bearish? What the hell does that mean?

Answer: If, for the sake of argument, the Dow collapses to 680 and the Transportation Average drops to 130, the typical portfolio of stocks is going to look like an overturned spaghetti dinner. As far as the stockholder is concerned, such figures would mean horrendous losses. But from the standpoint of the primary trend, as long as one or both Averages hold above the 1974 lows (i.e., 577.60 and 125.93), it's a primary bull market. And from the standpoint of the US, the Western world and the future of the free enterprise system (to say nothing of Wall Street and the stock market), it makes a tremendous difference whether we are in a primary bull market or not. If I am wrong, if the 1974 lows are both fated to be broken, then the nation is in for a very tragic period ahead.

For the record again, I believe that the primary trend of the market turned bullish last year. Nevertheless, due to the double non-confirmation (see last report), I have advocated cutting way back on stock holdings. If the September-October, 1975, lows of 784.16 and 149.38 are broken, I would then suggest (with great emphasis) that my subscribers be in a very, very defensive position and totally out of the market. It would not surprise me to see Industrials break below the 784.16 level with perhaps Transports holding (a downside non-confirmation). In that case, we would have a rather hopeful picture and a very sold out market.

Question: How far do you expect this secondary downtrend to carry?
Answer: I don't like offering ding-bat crystal ball opinions, but I will guess that it could carry far enough so that the majority will be convinced that the 1966-74 bear market is still on — or that a new bear market has started. They will be wrong in that (1) this downward reaction will probably be more severe than they had expected, and (2) a bear market will not be in force.

Question: With the secondary trend of the market down, what do you think the stock market is saying about the economy?
Answer: I feel that the market is telling us that business in 1976 is not going to meet the economists' expectations. The general consensus is that business is now "moving up" at a conservative pace, but that as 1976 wears on business will be fairly good and that (despite problems) 1976 should be a decent year. My own interpretation is that the market is telling us that it discounted the worst (at the 1974 lows), but that there are going to be a lot of very tough months during 1976.

One of the manifestations of "difficult times" is the variances and discrepancies between stocks and groups. For instance, in the same group we have a W.T. Grant (bankruptcy) and a Woolworth (doing beautifully). In carpets, for instance, we have a Ludlow (not doing well) and Mohasco (doing very well). We have a Chrysler (mmm!) and GM (doing all right).

A glance at the Quote Digest (PO Box 213, Wichita KS 67201) chart book of all NYSE charts shows fantastic divergences. On any page one can find stocks that are bullish and stocks that are bearish, stocks near 1975 recovery highs and stocks near their

 1974-75 lows. It's a hodge-podge very typical of the period after the recovery following a crash (as per 1933-34 or 1948 or 1938-39).

In other words, on both fronts, business and the stock market, the picture is scrambled with wide divergencies. The primary bull trend is keeping most stocks off their 1974 lows, but it certainly has not sent most stocks to new recovery highs. In business, I expect the same thing. It's going to be a weeding out of the men from the boys, and a survival of the fittest. The long rocket ride up, up and away no longer exists. Business is going to be tough, but also rewarding for the better outfits. For the mediocre outfits, in many cases it's going to be "meat-grinder city."

Question: In your last report you mentioned trading a few gold shares, but you said "I'm not a gold bull yet." Why aren't you more enthusiastic about gold (and silver)?

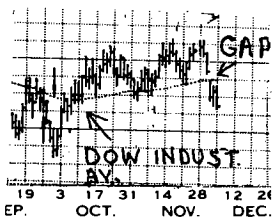
Answer: IF gold bullion is trying to base here, it will take time. Meanwhile, I feel that the stock market could also be discounting some amount of "dis-inflation" or actual deflation next year. With everyone zonked by the NYC situation, with the mood one of increasing conservatism, I don't think that gold is going to have the long-awaited runaway inflation base to send it skyward. The last thing that gold needs now is deflation. Yet if business sags and if debt expansion slows, we'll have at least a cessation of the inflationary trend and very likely a portion of actual deflation.

According to charts put out by Capital International Perspective (15, rue du Cendrier, CH 1201 Geneva, Switz.) only 4 of 19 industrialized nations are now showing a rising rate of change in wholesale prices (year to year basis). Furthermore, only 5 of 15 industrialized nations show a rising rate of change in industrial production. This slumping international picture (call it "correcting" if you wish) does not promise inflation for the year ahead.

Question: I note that you were quoted bearishly in the December 3 Wall Street Journal, in the December 8 Barron's, and in the December 15 Newsweek. The market broke 17 points on the day the WSJ printed your bearish comments. Were you responsible for the spill?

Answer: News always goes with the trend. But I hardly think that my reports can move the market. If, conceivably, they could, the impetus would probably last about two hours. Most readers know that I spend most of my time trying to figure out what the market is "saying," so that from that standpoint you might say that "the market moves me." A basic tenet of Dow Theory is that the primary trend can not be manipulated. Usually only important forthcoming economic trends move the secondary trend. Statements from very influential men can sometimes manipulate the daily trend, but such manipulations seldom last the day out. Personally, I plead powerless to being able to push Wall Street around.

Question: I note a "gap" in the Industrial Average at the 840 level which occurred between December 2nd and 3rd. Does this have to be filled?



Answer: I am not a gap-believer. In other words, I do not believe gaps have to be filled. It is of interest that a gap (still unfilled) occurred at the 670 level on the way up from last year's lows. So we have a gap at 670 and one at 840. Gaps usually imply exceptional power or utter exhaustion. I feel that the recent downside gap at 840 indicated exhaustion of buying power. I believe that the upside gap at 670 indicated massive power on the part of the buying forces. I do not go along with the thesis that either gap "has to be filled." Historically, the great majority of gaps have been filled in due time, and I would guess that in due time both of the aforementioned gaps will be filled (in other words, the market rises and it declines).

Question: I note that the 200-day moving average of the Dow Industrials is drawn in on your page 1 chart at 819. I also note that the Dow has been bouncing around and off this level. Is this significant?

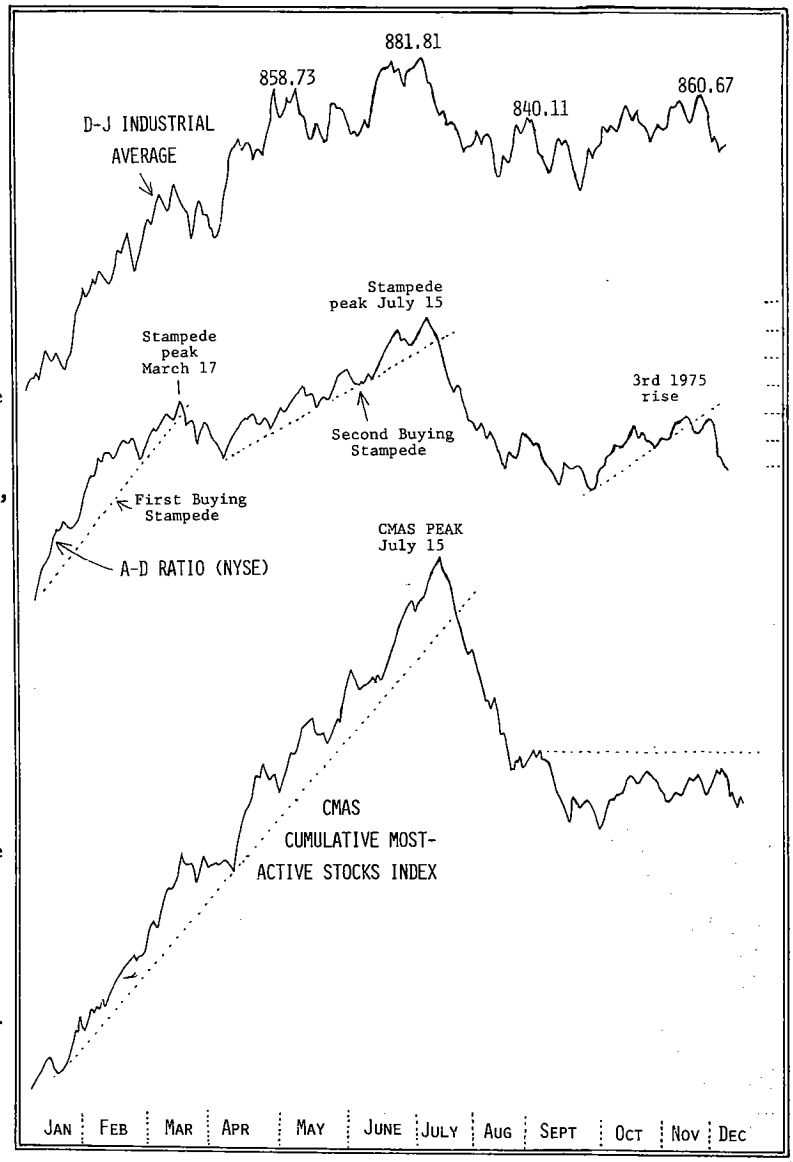
Answer: The D-J Industrial Average is made up of 30 stocks that are considered investment-grade issues (they compromise about 25% of the value of the entire NYSE). These Dow stocks tend to be bought by investment money (often termed "informed money"). The 200-day moving average (MA) is a statistically "smoothed" line showing the average price of the Dow Industrials over the past 200 trading days or approximately 9.5 months. This 200-day average price is sometimes called an "investment line," since it tends to show us what investment money is doing.

The position of the Dow (daily basis) above or below the 200-day MA is always significant. As a rule, any plunge by the Dow below the MA can be taken as a warning signal. If the Dow stays below the MA, and the MA then flattens out and finally turns down, the situation is indicative of a full secondary correction.

On December 8 and 9 the Dow bounced off the 200-day MA, but on neither occasion did the Dow close below the MA (i.e., below 819). This is the "logical" place for the Dow to find support. But if, during the period ahead, the Dow does drop below the 819 level, we will have the first breaking of the 200-day MA in this bull market. If that occurs, it will be important to see (1) whether the Dow remains below the MA, and (2) whether the MA thenrolls over and turns down. If these two actions take place, we will be reasonably sure that the current reaction is moving into a "nastier" phase, a phase which should include an ultimate selling climax (on high volume) — plus the usual indications of fear and even panic.

Conversely, I might add, a persistent refusal by the Industrials to close below the 200-day MA would be a hopeful sign. Such action, in fact, would represent the "technical spark" which could provide a rally into the Christmas period.

TECHNICAL CONSIDERATIONS: The action of the Dow together with the advance-decline ratio and the cumulative most-active stock index (CMAS) are worth studying carefully at this time (chart on page 5).



First, it should be understood that the A-D ratio measures the advancing or declining tendencies of all the stocks on the NYSE. The index is computed by taking the plurality of advancing or declining issues daily, and dividing this plurality by the number of issues traded (the latter to adjust for the constant increase in total corporations listed on the NYSE). There is a normal harmonious relationship between the Dow and the A-D ratio, which means that they should not only move in the same direction, but that they should confirm each other by penetrating comparable preceding levels. When this normal harmonious relationship is interrupted, it is usual for the market to erase the movement which produced the dis-harmony. Thus any divergences or non-confirmations in these two indices can be significant.

The 15 most-active stocks on the NYSE produce about 15% to 30% of daily volume. Thus the most-actives are a most important market gauge. The direction of the majority of the most actives often provides clues as to (1) what the "big money" is doing, and (2) which way the rest of the market will shortly be going. The CMAS line is, in effect, a cumulative advance-decline line of the 15 most-active stocks (daily), and I have found this indicator to be of great value in determining the trend of the market.

Turning to the A-D ratio, note that there have been three main upward movements in the A-D and the general market during the year 1975. The first, which I termed a "buying stampede," raised the A-D 8.80 points to a peak on March 17. I label any rise of 5 points or more (without an interruption of over 1 point) as a buying stampede, and the December to March explosion certainly qualified as a stampede by my definition.

The second major rise took the A-D from its minor April 7 low to a July 15 peak, a gain of 5.20 points. This move, although considerably shallower and less powerful than the first, also qualified as a buying stampede.

The decline from the July 15 A-D peak to the October 1 bottom was discouraging in that it was so severe — over 5 points on the downside. But more important, the decline broke the April A-D low (i.e., the low following the first buying stampede). From the October 1 low, the A-D ratio moved up again. As seen on the chart, the third rise was the most sluggish of all, adding a total of only 2.80 points to the A-D. But I held any bearish inferences in abeyance because (1) the Averages had produced such impressive downside non-confirmations during September and October, and (2) because I believe in giving the primary bull trend every benefit of the doubt.

On November 28 the third A-D rally of 1975 topped out. In the face of the double non-confirmation in the Averages, the A-D plunged, wiping out all of its November upside progress in the space of three trading days (i.e., December 1st through the 3rd). A few days later (Dec. 9) the A-D slid to a level that served to erase almost all the A-D gains since the October 1 low. That was enough to give the "ominous" label to the whole A-D picture (at least, as far as this writer is concerned).

Now let's turn to CMAS. The rise from the December low to the July 15 peak came in the form of an almost interrupted upward "power-thrust." Even the March-April interruption in the A-D ratio failed to dent the buying surge which dominated the most active list. Suddenly, on July 15, the rise in the most actives ended. With a vengeance CMAS smashed down to a late-September low. From there, CMAS pushed up in rather feeble fashion, but again I allowed for the NYC situation, the fact that the primary trend was bullish, and the generally psychology of fear that was gripping Wall Street and the nation.

Despite my "allowances," it is well to note that CMAS acted weaker than either the Dow or the A-D ratio. Note that the CMAS failed during October through December to better its September high, a peak that I have identified on the chart with a horizontal dotted line.

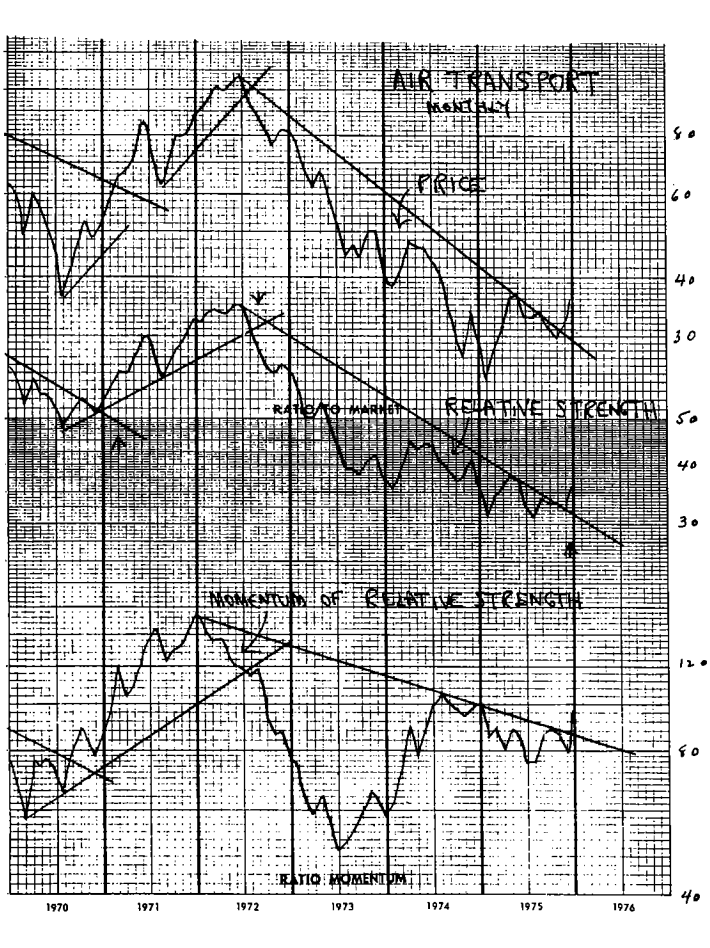
Following the early-December double non-confirmation in the Averages, CMAS plunged to lower levels along with the other market indicators. CMAS was one of the weakest (and therefore one of the most accurate) of the indicators during the post-September advance.

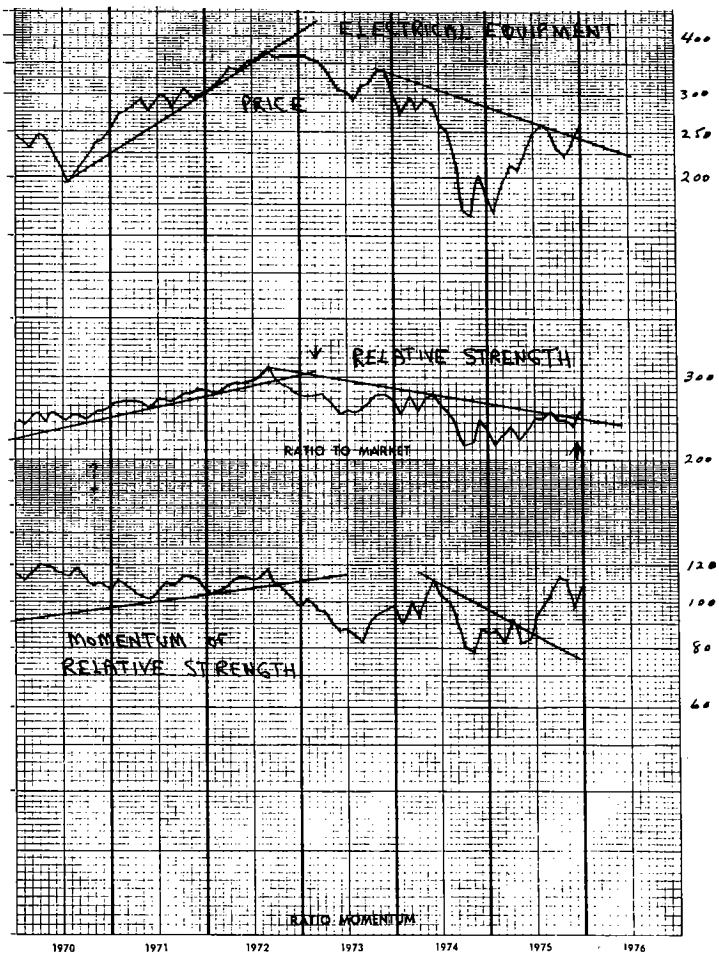
What can we say now of the Dow and its two cohorts as pictured on the chart? The strength or weakness of the market can be judged in the period ahead by the ability of the Dow and these two indicators to hold above their September-October lows. I would consider a penetration of the Dow below the October 1 low (784.16) as extremely bearish if accompanied by a Transport penetration below 149.38. A confirming break by the A-D ratio and CMAS would hardly brighten the situation.

All of the action I have been discussing has taken place in the Thanksgiving to Christmas period, a period when, historically, the odds are extremely favorable for the market to advance. Often, what the market does not do is as important as what it does do. The damage done by the current decline is now severe, but we will have to assess the whole situation when the current stage of the decline has ended. The power of the next rally will also be important in gauging the situation. A weak rally from here is the last thing this market needs.

With the A-D ratio so near its extreme October low, it would not be at all surprising to see this index break below the October low (thus wiping out most of the A-D gains for 1975). However, a new A-D low could occur without the Industrial Average's confirming (i.e., without Industrials breaking below 784.16). Such a downside non-confirmation could be the technical trigger which would set off a "year-end rally." My own opinion, however, is that I would be very skeptical of any upside action stemming from a new A-D low, unconfirmated by a new low on the part of Industrials.

Conclusion: The Industrial Average and the A-D ratio are now badly out-of-gear, while CMAS offers little in the way of encouraging action. So far, it doesn't look like Wall Street and Santa Claus are going to get together for Christmas, 1975.





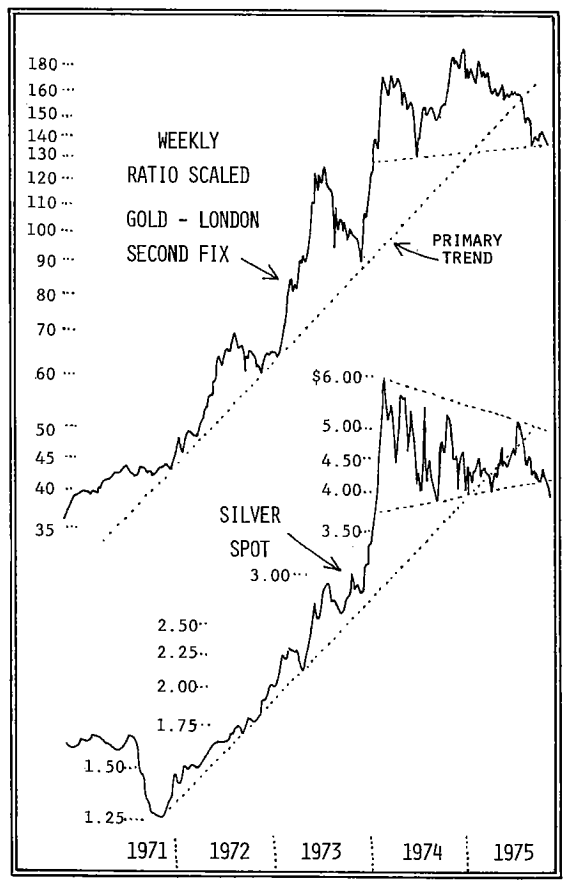
STOCKS: I'm not recommending any purchases in this area, but for the record two groups which have turned bullish in relative strength this month are Air Transport and Electrical Equipment (the latter includes such stocks as Cutler-Hammer, Emerson Electric, I-T-E, McGraw Edison and Square D). I am including Ray*Signals' excellent relative strength charts illustrating the upturn in RS for the Airlines (Ray*Signals, 43 Lake Ave., Montrose PA 18801). Since Airlines are a component of the Transportation Average, this should tend to offset the poor RS which is now being evidenced by the Rails.

Incidentally, the momentum of RS shown on these charts is a six month rate of change line of RS, and this line indicates whether the rate of RS is improving or not. Thus, RS in a group can be bullish, but if the RS momentum line is declining, the RS itself will ultimately turn down. The RS momentum line therefore provides early signals of RS changes, and I find it a very valuable concept. Note the power of the RS and RS momentum in the Air Transport industry. This group could be one of the leaders on the next important advance in the market.

Other individual stocks which have turned up on a RS and RS momentum basis this month are Coca Cola, DuPont, FMC, Gillette, Amer. Gen. Insurance and Richardson-Merrell. Downward reversals in RS and RS momentum among individual stocks for December are Bucyrus Erie, Continental and Getty Oils, Inland Steel and (highly-touted) Chessie.

GOLD & SILVER: There are pros and cons in the gold-silver story. On my ratio-scaled weekly chart, the patterns for both precious metals are bearish. Gold and silver have both broken (many months ago) their long-term or primary trendlines. Gold is in a massive "head-and-shoulders" type top formation, but I would say that it would take a breaking of the 1975 low of 128.75 to send this pattern into a downwise orbit.

Silver has formed a huge triangle pattern, and despite all the current "silver-for-inflation" talk, I see the pattern, with its recent breakout on the downside, as bearish.



"Why," you ask, "why are they looking so grim? My best answer is fear of deflation or non-inflation, and the attraction of high interest rates on good bonds and preferred, rather than the hedge of no-interest gold and silver.

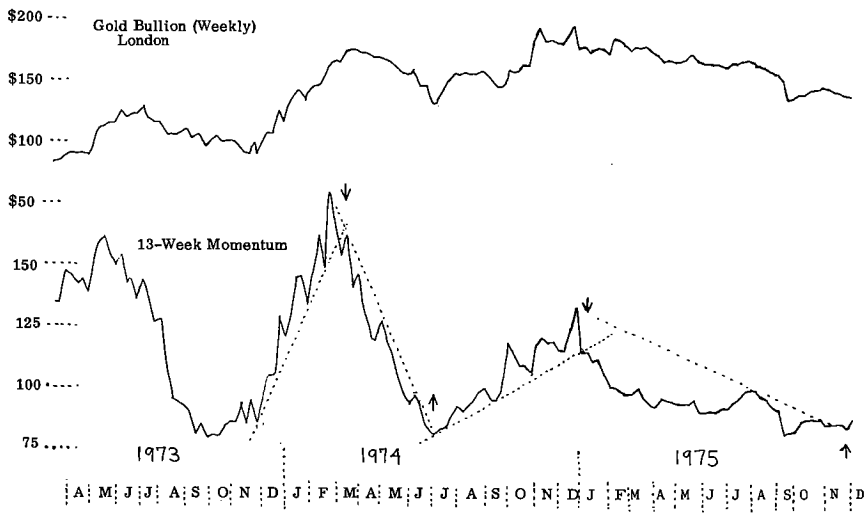
Against the long-term picture, the cyclical or intermediate-term picture for gold is brighter. My 13-week momentum chart for gold (see chart below) has turned up, and this "should" mean a bit more oomph under bullion over coming months. Does this mean that one should run out and buy bullion and gold shares for a big rise? Well, I'm still somewhat skeptical. My point & figure chart of gold bullion has not turned bullish yet, but I'll say again that for those who can't sleep unless they have some gold positions, the two stocks I like best are Homestake (which is really diversifying out of gold) and Amgold (ADR) which at 31-33 is half its old high, selling under its entire 1974 range and rather near its 1973 low.

* * * * *

Oct 31, DJIA 836.04; PTI 339; A-D ratio -29.56
Nov 7, DJIA 835.80; PTI 357; A-D ratio -29.30
Nov 14, DJIA 853.67; PTI 370; A-D ratio -28.69
Nov 21, DJIA 840.76; PTI 361; A-D ratio -29.11
Nov 28, DJIA 860.67; PTI 385; A-D ratio -28.54
Dec 5, DJIA 818.80; PTI 359; A-D ratio -30.11

The little clip at right is by Will Rogers, May 20, 1939. What is it the French say about "The more things change, the more they're the same."

Next mailing: December 24th.



New York is human for the first time in years. It is broke, just like everybody else, and is running around in a circle, trying to pay what it owes. They got an $18 billion first plaster, and now they are pop-eyed, trying to get a second mortgage.

They will eventually find out they are just like other folks; they will have to cut down. No taxpayer is going to make 'em a loan if they are going to keep as much help around as they always have. — May 20, 1939